The POWER of the PURSE

How Investors Can Restore Integrity to Our Financial Markets

PHIL ANGELIDES
CALIFORNIA STATE TREASURER
2002

PHIL ANGELIDES

TREASURER
STATE *of* CALIFORNIA

Dear Friend:

Throughout the course of this year, we have seen the integrity and stability of our financial markets buffeted by revelations of corporate malfeasance, deception, and fraud. Virtually every day for months, a new, shocking story of impropriety has come to light. Too many corporate officers and directors, financial consultants, accounting firms, and investment banks have been caught up in scandal. The systemic breakdown in ethics and standards of conduct has shaken the very foundations of our financial institutions, damaged our economy, and harmed millions of Americans.

Restoring the public's faith in our financial system is critical to our sustained economic prosperity. Our willingness to invest in the future is predicated on the belief that our financial markets operate with integrity, transparency, and fairness—a belief that has been severely tested in the past year.

As the State's chief investment officer, and as a trustee of over $270 billion in state pension and taxpayer funds, I am deeply committed to safeguarding the public treasury; protecting pensioners, families, and taxpayers; and restoring the faith and confidence of investors. That is why I have taken an active role in advancing corporate reform—using the power of California's considerable investment portfolio and market presence to combat corporate fraud and abuse and to set new standards of integrity and corporate responsibility.

Our office has told investment banks and money managers that they must meet tough conflict of interest and disclosure rules or risk losing the right to do business with the State. We have banned investments in, and business dealings with, expatriate U.S. companies that relocate—in name only—to tax havens such as Bermuda and the Cayman Islands to avoid taxes and weaken shareholder rights. We brought together pension and investment officers from 14 states, responsible for managing over $1 trillion in assets, to collectively push for needed reforms. And, we will continue to take action to help renew the faith of investers in the integrity of our financial markets.

The Power of the Purse: How Investors Can Restore Integrity to our Financial Markets outlines the principles that are guiding our efforts to promote reform and details some of the steps which we have already taken to translate principles into action. It represents our commitment to ensure that California plays its rightful role in restoring integrity and accountability to the financial framework so necessary for our future economic prosperity. Most importantly, it is a call to action for investors across the nation to use their market strength as a weapon for corporate reform.

To achieve lasting reforms and long-term market stability will require a sustained effort by public and private sector leaders in the months and years ahead. Our office intends to continue to wield "the power of the purse" to help ensure that worthy reforms become the new realities of the financial marketplace.

We look forward to working with you and others to advance the cause of reform and economic progress.

Sincerely,

PHIL ANGELIDES
State Treasurer

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The POWER of the PURSE

How Investors Can Restore Integrity to our Financial Markets

Not since the days of the Robber Barons of a century ago, or perhaps the dark days following the stock market crash of 1929, has America seen its financial institutions so heavily battered by revelations of corporate malfeasance, deception, and fraud.

Mark Twain once said, "History does not repeat itself, but it rhymes." Although the scandals that have come to light over the past year differ in detail from those at the beginning of the 20th Century and those that contributed to the crash of 1929, the results are similar. Insiders were profiting while small investors were sustaining losses, corporate officers were receiving outsized compensation while their firms were going bankrupt, and overleveraged companies were falsifying their accounting to mislead unwary shareholders. In that sense, recent events "rhyme" with those of the past.

> *Restoring integrity and accountability to our financial system and instilling a new ethos of corporate responsibility are matters of critical importance to our sustained economic well being.*

Just as it has in the past, this spate of corporate scandals has had a profound effect on our economy. Trillions of dollars have been lost in the stock market. Too many families and pensioners have seen their savings and retirements wiped out. Responsible, honest companies across the nation have been hurt by unscrupulous corporate renegades. The confidence of investors has been severely shaken. And, the economy and our financial institutions have been weakened by a pernicious infection of greed and dishonesty.

Restoring integrity and accountability to our financial system and instilling a new ethos of corporate responsibility are matters of critical importance to our sustained economic well being. Our economic strength of today and tomorrow is dependent on the willingness of individual and institutional investors to take prudent risks by investing in markets that they believe are operated with openness and integrity and in companies managed responsibly and honestly.

As the fifth largest economy in the world, California has an abiding interest in ensuring that the nation's financial system commands the confidence of investors around the world. California's economic growth has been fueled by investments in new enterprises and new technologies—with investors willing to take ample business risks in the framework of trusted financial markets. And, the State, through its $270 billion pension and investment portfolio, is one of the most significant shareholders and investors in the American and global economies—with much at stake for California pensioners and taxpayers.

The Golden State is a Major Investor and Shareholder in the American Economy

The financial crisis resulting from the breakdown in ethics and accountability has had a dramatic impact on California, as it has on the nation as a whole. The FBI has reported that the money stolen from every bank robbery in America between 1996 and 2000 totaled $204 million. But in less time than it would take to pull a bank heist, WorldCom's accounting fraud cost California's teacher and public employee pension systems over $850 million. While the State's pension funds remain well funded, it is clearly in the interest of the funds and all Californians to restore the market stability and investor confidence so necessary for long-term economic growth.

...no reform effort will be complete unless the owners of American corporations—institutional and individual shareholders alike—also commit themselves to exercising the power of the purse to bring about a new era of corporate responsibility.

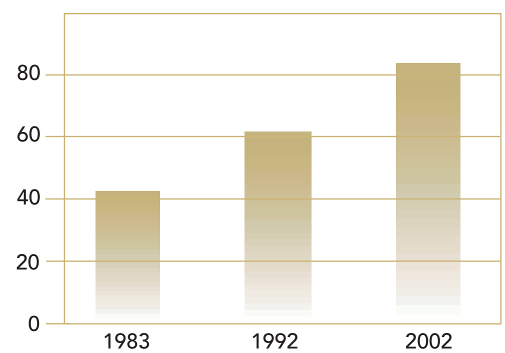
Renewing public trust in corporate America and in the nation's financial institutions will require the full commitment of public and private sector leaders in the months and years ahead. It will require constant vigilance to ensure that new standards of ethical conduct are ingrained in the nation's business practices. And, it will require a multi-pronged effort across a broad front to change the underlying culture which gave rise to the crisis at hand.

Central to this commitment must be the reestablishment of a federal regulatory and enforcement system which ensures that the financial markets function in the public interest. Recently enacted federal legislation and regulations are clearly key components in restoring the confidence of investors. For this reason, over the course of the past several months, California State Treasurer Phil Angelides has actively supported key legislative initiatives on corporate reform such as United States Senator Paul Sarbanes' legislation, the Public Company Accounting Reform and Investor Protection Act of 2002, which was signed into law in July 2002.

However, no reform effort will be complete unless the owners of American corporations—institutional and individual shareholders alike—also commit themselves to exercising the power of the purse to bring about a new era of corporate responsibility.

A renewed era of activism by America's investors is fundamentally important given the new contours of our financial markets. In the 1990s, the public equity markets witnessed remarkable growth and change. Corporations enjoyed unprecedented access to capital. There were over 2,800 stock offerings from 1995 to 1999. By January 2002, more than 84 million Americans from all walks of life owned stock, up from just over 42 million individuals in 1983. And, as of 2001, institutional investors such as pension funds and mutual funds owned approximately 46 percent of the nation's publicly-traded equities.

84 Million Americans Owned Stock in 2002 Compared to 42 Million in 1983

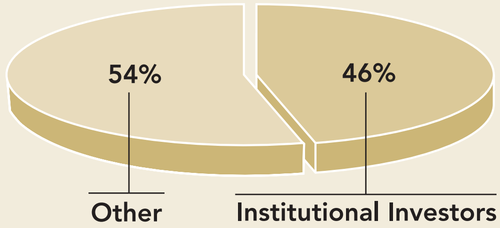


Source: *Investment Company Institute*

Individual and institutional investors represent an important, potential force for constructive change in the ethics and accountability of our financial institutions. Over 200 years ago, an Irish patriot named John Philpot Curran said, "Eternal vigilance is the price of liberty." American investors should paraphrase that aphorism by declaring: "Eternal vigilance is the price of a sound economy." Investors must help ensure that new standards of corporate and financial responsibility are firmly woven into the fabric of the nation's business practices. To accomplish this end, the age of investor complacency must be replaced by a new era of investor democracy.

California, with its significant pension and investment portfolio, has a special obligation and opportunity to be a leading force for change as the nation struggles to regain its financial footing. The State's pension funds have played an important role in the past in promoting corporate governance reform. Yet, the magnitude of the present crisis demands a heightened level of engagement by all investors.

Institutional Investors Own 46% of All U.S. Stock



Source: Investment Company Institute

That is why California State Treasurer Phil Angelides has stepped forward during these critical times to advance an agenda of corporate reform—using California's significant market presence to help restore integrity and accountability to the marketplace.

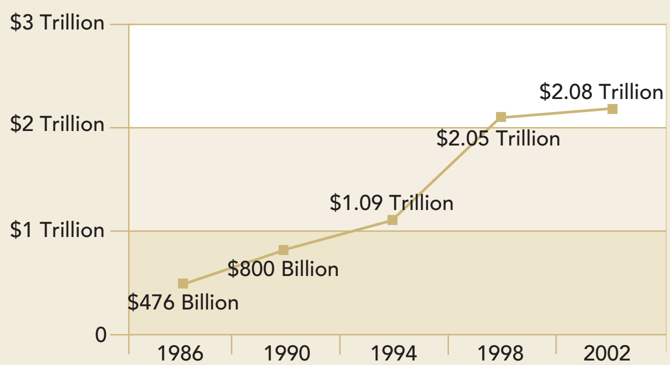
As the State's chief investment officer, the Treasurer sits on the Boards of the California Public Employees' Retirement System (CalPERS), the largest public pension fund in the country with approximately $135 billion in assets, and the California State Teachers' Retirement System (CalSTRS), the nation's third largest public pension fund with approximately $93 billion in assets (as of July 31, 2002). The Treasurer is also responsible for managing the Pooled Money Investment Account (PMIA), with approximately $46 billion in taxpayers funds on hand (as of July 31, 2002), and for overseeing bond and debt issuances on behalf of the State—which are expected to exceed $30 billion in 2002. These financial roles afford the California State Treasurer's Office with the opportunity to influence business practices and corporate governance in a way which benefits the economy, pensioners, and taxpayers.

...investors can use their market force to restore integrity to our financial system if they are willing to mobilize and take strong action in the cause of corporate reform.

The Power of the Purse: How Investors Can Restore Integrity to our Financial Markets outlines the principles which the California State Treasurer's Office believes must be at the center of an emboldened investor movement. These principles are based on a simple premise: that investors can use their market force to restore integrity to our financial system if they are willing to mobilize and take strong action in the cause of corporate reform.

The principles contained in ***The Power of the Purse*** are guiding the efforts of the Treasurer's Office to promote reform and have been the basis for the actions that the office has taken to

U.S. Public Pension Fund Assets Quadruple from $476 Billion to Over $2 Trillion



Source: Federal Reserve, *Flow of Funds Accounts of the United States* date. They represent the Treasurer's commitment to ensure that California plays its rightful role in promoting corporate responsibility and restoring accountability and integrity to our nation's financial framework.

These principles are guideposts for a new era of investor engagement—they are not meant to be a substitute for ongoing corporate governance reform efforts or the enactment and enforcement of needed laws and regulations. Indeed, investors must remain committed to bringing about the structural changes needed to ensure responsible governance of America's corporations and must remain vigilant to ensure that federal regulators do their part to uphold the highest standards of conduct in the marketplace.

The Treasurer's Office calls on investors from across the nation to take the actions embodied in the principles outlined below.

Demand Ethical Conduct

Investors—particularly institutions such as pension funds—must use their market strength to demand the highest standards of ethical conduct and transparency. Significant investors must make it clear that they expect those with whom they do business—such as investment banks, money managers, financial consultants, and accountants—to meet the rigorous standards of conduct required to restore confidence in the operation of our financial institutions. They must embrace the commonsense practice of transacting business only with companies known for their honest dealings. Consequences for poor corporate behavior and ethical lapses will result in reforms in the marketplace.

To put this principle into practice, in July 2002, Treasurer Angelides joined New York State Attorney General Eliot Spitzer, North Carolina Treasurer Richard Moore, and New York State Comptroller Carl McCall in adopting a set of Investment Protection Principles which require investment banks and money managers to meet new standards of disclosure and eliminate their conflicts of interest or risk losing the right to do business with their states. At the Treasurer's urging, these principles have since been adopted by both CalPERS and CalSTRS, among others.

Shareholders should start acting like the owners they are.

Act Like Owners

Shareholders should start acting like the owners they are. They must make the most of the voting power that they have today while they mobilize to strengthen their rights to have a meaningful say in the companies they own. Shareholders can organize to dump an incompetent, self-serving, or corrupt board of directors, or reject a stock option plan that serves only the interests of corporate executives. But to do so, they must be willing to do the work that democracy requires, namely, to organize effectively to translate votes into real corporate reform. While shareholders inevitably will not agree on every issue, they must work to find common ground to take actions which reverberate through the marketplace and change the discourse in corporate boardrooms across the country.

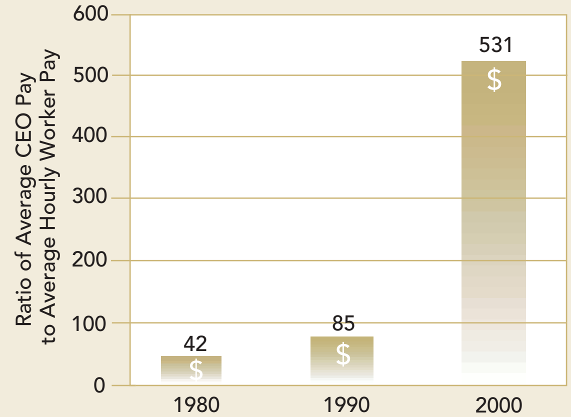
The California State Treasurer's Office is committed to working with other institutional investors to mobilize in the cause of corporate democracy. In this vein, Treasurer Angelides co-convened an "Investor Summit" of public financial leaders from 14 states, responsible for the investment of more than $1 trillion in assets, to develop an agenda for common action. At this meeting, held in August 2002, the group vowed to work collectively to expand the drive for improved corporate accountability.

Reward Value, Not Greed

Our free enterprise system is at its best when it fosters innovation, productivity, and broad participation in economic progress. Shareholders must be willing to support corporate compensation policies which reward dynamism, performance, and the creation of long-term value. But, that is different than sanctioning a culture of greed.

According to Business Week, the average CEO of a major corporation made 42 times the average hourly worker's pay in 1980, 85 times the average hourly worker's pay in 1990, and a staggering 531 times the average hourly worker's pay in 2000.

Average CEO Pay Skyrockets to 531 Times that of Average Workers



Source: *Business Week annual executive pay surveys*

Shareholders have an obligation to restore rationality to the realm of executive pay—rewarding effective corporate leadership, while curbing excesses which undermine the enduring strength of the American economy and jeopardize the faith of the investing public in the fairness of the marketplace.

Pursue New Investment Strategies

Pension funds and other institutional investors need to rethink the passive investment strategies which they have employed for years. Many institutions, in effect, replicate the stock indexes to diversify their risk. But it is now clear that some companies are dealing from a stacked deck. Institutional funds need to embrace more active forms of portfolio management to respond to the challenges posed by the changed investment environment in which they are operating.

In asset classes such as real estate and private equity, investments are made only after the completion of significant due diligence in which the investment strategy as well as the competence and integrity of the proposed investment partners are fully vetted. While it is not possible to take the identical approach to investment in public equities, institutional investors must examine innovative strategies that protect their interests from corporate malfeasance and that alert public companies to the fact that they are more thoroughly examining the companies in which they hold a stake. And, investors must be willing to cease investments in companies resistant to reform.

...company executives who relocate offshore to avoid taxes or bend environmental laws or exploit their workforce would not think twice about enriching themselves while shortchanging their shareholders.

Send a Message: Company Conduct Counts

Investors need to send a clear message: company conduct counts. Too often, institutional investors have tried to construct a wall between their investment decisions and corporate responsibility. Yet, in doing so, they ignore the relationship between good corporate citizenship and good investments. Indeed, company executives who relocate offshore to avoid taxes or bend environmental laws or exploit their workforce would not think twice about enriching themselves while shortchanging their

Quarter-by-quarter expectations need to be replaced by shareholder and management commitment to the creation of true wealth over the long term.

shareholders. The California State Treasurer's Office already is setting an example by prohibiting business dealings with expatriate U.S. corporations that relocate offshore—in name only—to dodge taxes and escape legal protections for shareholders.

Reward the Creation of Long-Term Value

Investors need to help good companies do the right thing. For example, they must encourage people of proven integrity to serve on corporate boards, and compensate them appropriately. Most importantly, shareholders should stop demanding short-term results at the expense of all else. They should reward executives and workers for sustained performance. Quarter-by-quarter expectations need to be replaced by shareholder and management commitment to the creation of true wealth over the long term.

Conclusion

Investors can and must play a pivotal role in renewing faith in our financial system. Without their full commitment, there can be no systemic reform and lasting change.

Investors cannot prosecute company executives who break the law. But they can make it clear that they will not tolerate corporate malfeasance and that they will not countenance those who violate the ethical standards that are the basis of an economy of enduring strength. Investors, large and small alike, from across the country, must join in a new era of investor democracy and action.

American investors must be prepared to do their part to rid the markets of dishonesty and greed, and to restore an open, fair, and free economy that has always been part of our national heritage. Only then can we renew the faith in our financial system and sustain America's economic success into the 21st Century.

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Actions taken to date by California Treasurer Phil Angelides to use the "power of the purse" to restore integrity to our financial markets…

July 1, 2002 — **Investment Protection Principles.** Treasurer Angelides joined New York Attorney General Eliot Spitzer, North Carolina Treasurer Richard Moore and former New York Comptroller Carl McCall in adopting a set of Investment Protection Principles, which require investment banks and money managers to meet new standards of disclosure and eliminate their conflicts of interest or risk losing the right to do business with their states. At the Treasurer's urging, these principles were also adopted by the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS).

July 25, 2002 — **Corporate Expatriation.** The Treasurer prohibited investments in, and business dealings with, expatriate U.S. corporations that relocate offshore – in name only – to avoid taxes and weaken legal protections for shareholders.

August 12, 2002 — **Investor Summit.** Treasurer Angelides co-convened an Investor Summit of public financial leaders from 14 states, responsible for the investment of more than $1 trillion in assets, to develop an agenda for common action. At the meeting, the group vowed to work collectively to expand the drive for corporate accountability.

October 2, 2002 — **Mutual Fund Proxy Voting.** At the Treasurer's urging, CalSTRS voted to make its proxy policies and votes public on its web site; urged its money managers to disclose their proxy policies and votes; and urged the Securities and Exchange Commission (SEC) to adopt strong regulations requiring disclosure of proxy votes by mutual funds. Also at his urging, in November, CalPERS took similar action with regard to its money managers and the SEC.

October 24, 2002 — **Enforcement of Investment Protection Principles.** The Treasurer's Office completed its initial review of investment bank compliance with the Investment Protection Principles; notified 22 banks that their level of compliance was unacceptable; and set a January 15, 2003 deadline for full compliance. One firm, HSBC, was notified of the Treasurer's intent to suspend them for noncompliance with the Principles, making it ineligible to do business with the State's $50 billion investment pool. HSBC responded by agreeing to fully comply with the principles.

November 18, 2002 — **Shareholder Resolutions to Corporate Expatriates.** CalPERS, at the request of Treasurer Angelides, launched a drive against the deceptive practice of corporate expatriation, voting to spearhead shareholder resolutions at McDermott International, Tyco International and Ingersoll-Rand urging them to repatriate. In December, CalSTRS took similar action with respect to Tyco and Ingersoll-Rand.

December 5, 2002 — **Removal of expatriate corporations from S&P 500 Index.** The Treasurer initiated a national effort by major institutional investors to urge Standard & Poor's to remove offshore companies, including six corporate expatriates, from the S&P 500 Index, which S&P describes as the "premier index for large cap U.S. stocks." Nine state finance officials and leading national labor officials joined this effort.

March 6, 2003 — **Office of Pension Protection and Market Reform.** Treasurer Angelides proposed the creation of a new California Office of Pension Protection and Market Reform – a joint operation of CalPERS and CalSTRS, the nation's first and third largest public pension funds. The office would strengthen California's clout in advancing an agenda of corporate reform. It also would protect state pension fund members and their assets by seeking redress and restitution for harm done and losses caused by corporate malfeasance; deterring future misconduct; and pursuing the corporate and financial market reforms necessary to restore integrity to the market place.

March 6, 2003 — **"Come Home To America" Campaign.** Treasurer Angelides, public pension funds, state and local finance officials, and labor unions joined together to score significant victories in the fight against corporate expatriation. As a result of the "Come Home to America Campaign," more than 26 percent of Tyco International Shareholders voted, on March 6, 2003, to leave Bermuda and bring Tyco back to the United States; on March 25, 2003, McDermott International agreed to work toward reincorporating from Panama back to the U.S.; and on March 30, 2003, a stunning 41.4 percent of Ingersoll-Rand shareholders voted to reincorporate in the U.S.

March 26, 2003 — **State Legislation to Curb Expatriation.** Treasurer Angelides sponsored legislation to ban state contracts with expatriate corporations and to close state tax loopholes that benefit those companies. Senate Bill 640, introduced by Senator John Burton, was enacted into law, prohibiting State agencies from contracting with publicly held U.S. corporations that have expatriated. Another measure, Senate Bill 1067, authored by Senator Jackie Speier, would close tax loopholes that allow expatriates to annually avoid an estimated $10 million in California taxes.

April 17, 2003 — **New Standards for Executive Compensation.** Treasurer Angelides proposed new standards for equity compensation plans – including stock options – for the 1,000 largest companies in which the State's two large public pension plans invest their money. Under Angelides' proposal, CalPERS and CalSTRS would vote to support equity compensation plans if the plans award 5 percent or less of the total compensation to the top five executives of the company. In addition, the plans must provide vesting schedules of four years or longer. On June 16, 2003, these standards were adopted at CalPERS. On July 9, 2003, CalSTRS adopted the "5 percent" standard and agreed to encourage minimum vesting periods of five years.

May 8, 2003 — **Tough New Requirements Applied to Investment Banks.** Acting in the wake of the landmark settlement of enforcement actions against 10 large investment banks, Treasurer Angelides imposed tough new requirements on all investment banks that want to do business with the State. The action made California the first state in the nation to apply and expand the tough new reforms of the Wall Street settlement to each of the 69 firms eligible to handle issuance of State bonds and the 57 broker/dealer firms that do business with the State's investment fund. These tougher new standards replaced the Investment Protection Principles adopted in July 2002. CalSTRS adopted the new standards on July 9, 2003, and CalPERS adopted them on August 18, 2003.

June 30, 2003 — **SEC Scores "Incomplete" on Progress Report.** Joining six other state treasurers, Treasurer Angelides issued a progress report on the SEC's corporate reform efforts and called upon SEC Chairman William Donaldson to move quickly to complete action on those reforms crucial to the protection of shareholders before the start of the upcoming proxy season.

September 16, 2003 — **Call for Reform at the New York Stock Exchange (NYSE).** Treasurer Angelides was the first state financial officer to call for NYSE Chairman Richard Grasso to resign following disclosure of Grasso's $188 million compensation package. Grasso resigned on the following day, September 17. On September 24, Treasurer Angelides and financial officers from six other states – entrusted with overseeing combined assets of over $568 billion in state and taxpayer funds – called for a thorough, independent examination of the NYSE's operations and governance in order to begin the process of restoring the public's trust and confidence in the Exchange. On October 14, 2003, interim NYSE Chairman John Reed – at a meeting with Angelides and other state treasurers and public pension fund leaders – confirmed that he had launched an independent probe of the Exchange and that it would be completed within two months.

October 2, 2003 — **SEC's Proposed Proxy Access Rules.** Treasurer Angelides joined an 11-member group of state and local pension officials in opposing proposed SEC rules containing severe limitations to shareholder proxy access. The officials, representing assets of more than $640 billion, called for new rules that strengthen shareholder rights to fair corporate elections.